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THE SECOND MEETING OF THE AUSTRALIA-HONG KONG RMB TRADE AND INVESTMENT DIALOGUE, 22 MAY 2014

It is a pleasure to be with you today and I thank you for participating in today's dialogue.

The Australia-Hong Kong RMB Dialogue provides a unique opportunity for considering the implications of RMB internationalisation, as well as its attendant challenges and opportunities.

Before I continue, let me thank the Hong Kong Monetary Authority for their efforts as host of this year's dialogue. Although it's only been a year since our last dialogue, at which I had the pleasure of speaking, there have been some significant developments.

Most notably, at last November's Third Plenum, the Chinese Government reaffirmed its commitment to pursue a financial liberalisation agenda, including reiterating its intention to internationalise the RMB.

We know from our interactions with the policymakers and regulators in Beijing that they are serious about reform. While many commentators are impatient about the pace of reform, measures to further open China's financial sector are actually happening at a rapid pace.

The Shanghai Free Trade Zone represents a crucial testing ground for China's next wave of financial sector opening, and Australian banks are participating actively in this pilot.

The RMB's daily trading band has been widened to 2 per cent around the reference rate, allowing for greater two-way exchange rate movements. The authorities have also announced plans to liberalise interest rates within two years.

It has also been a busy year for developing Australia into an offshore RMB market. Most recently, the Australian Prime Minister announced that Australia and China would work towards making Sydney an offshore RMB centre.

In February, we saw the launch of a 'near real-time' settlement service offered in partnership between Bank of China and the Australian Stock Exchange (ASX).

The arrangement draws partly on Bank of China's access to liquidity in their operations here in Hong Kong—where they are, of course, the official clearing bank. Apart from being an important milestone in the development of Australia's own offshore RMB market, this also underscores Hong Kong's ongoing role in the development of offshore RMB markets globally.

And in early April, Bank of China's Sydney branch issued CNH 2 billion worth of 2-year bonds, the largest RMB bond issue in Australia to date.

We have also seen the Chinese authorities take further steps to link the offshore and mainland financial markets. These steps include a pilot program allowing mutual stock access between the Shanghai and Hong Kong stock exchanges and the decision in March to further expand the Qualified Foreign Institutional Investor scheme, including for RMB-denominated investments.

Taken together, these measures underline the Chinese authorities' continued multi-track approach, with the offshore RMB market being developed at the same time as domestic financial market reforms.

As I noted at last year's meeting, this approach recognises that the continued integration of the mainland and offshore RMB markets will generate further financial market development on the mainland. But it also recognises that China's financial markets are not yet prepared for uninhibited capital flows.

Given all this, Hong Kong is likely to stay at the forefront of the offshore RMB market. It will also continue to be an important testing ground for currency liberalisation and the financial reform process.

This reflects the deep economic and cultural connections with the mainland and Hong Kong's natural constituency of individuals and corporates wishing to hold, and transact in, RMB.

Capital account liberalisation and financial integration

Examining RMB internationalisation in isolation gives us only partial visibility of the road ahead.

It is part of China's broader financial opening.

This broader story of capital account liberalisation – which requires the substantial removal of remaining capital controls – is about China's financial integration with the rest of the word, and the unprecedented reallocation of global financial assets this will involve.

Today, China accounts for around 11 per cent of both world trade and global GDP[1], but only accounts for 3 per cent[2] of gross holdings of overseas assets and liabilities globally. If China's gross investment position was similar to that of the US today, the sum of its gross external assets and liabilities would triple, increasing by around US$16 trillion.

An expansion in China's international footprint of this scale would have far-reaching implications for global financial markets. While US-style gross investment positions may not be in prospect straightaway, ANZ has suggested that China's share of global equity market capitalisation could overtake the US' by 2025, reaching a share of about 25 per cent of global capitalisation.

This, in turn, will be part of a broader rebalancing of economic power towards Asia, with some estimates suggesting that Asia's share of global financial assets could comprise up to 50 per cent of the global total by 2030.[3]

Greater financial integration provides an opportunity for countries like Australia to benefit, with Australia a significant net importer of capital. By way of example, the stock of Chinese investment in Australia by the end of 2013 was more than fourteen times the amount in 2005. But, at A$32 billion, this represents only around 1 per cent of the total stock of foreign investment in Australia.

Of course, further domestic reforms are still crucial and will ultimately shape the nature of China's financial integration. Similarly, interest rate liberalisation, exchange rate flexibility, as well as institutional and governance reforms, all continue to represent important preconditions to a stable opening of China's capital account.

We shouldn't get ahead of ourselves; China has an immensely challenging reform agenda with a difficult starting point. While China wants to introduce more market signals into its financial markets, it is also dealing with the legacy of a highly managed system with many distortions.

Financial system risks like excessive credit growth and shadow banking add a further layer of complexity. It is therefore important for reform to be appropriately sequenced, and that's been the approach to date.

Australia has first-hand experience of some of the challenges associated with capital account liberalisation and introducing exchange rate flexibility. While Australia's overall experience with financial deregulation has been positive, the

[1] IMF statistics (2012), GDP is on market exchange rate basis.
[2] *Bringing down the Great Wall? Global implications of capital account liberalisation in China*, Bank of England, Quarterly Bulletin, 2013 Q4.
[3] *Caged Tiger: The Transformation of the Asian Financial System*, ANZ Insight, Issue 5, March 2014.

reforms of the 1970s and 1980s did not happen overnight and they brought new risks, some of which materialised, as many in this audience would appreciate.

Financial cooperation: maximising opportunities

Greater financial integration can provide benefits to all countries in the region. It facilitates the diversification of direct and portfolio investment, provides opportunities to spread risk and helps to share expertise. It can help drive growth in the region by creating an environment in which good projects are funded – and bad ones are not – thereby helping address the infrastructure needs of the Asian region, which the Asian Development Bank assesses as being around US$8 trillion this decade.

Bilaterally, there is also room to further develop our trade and investment with China. Australia is already China's seventh-largest merchandise trading partner and a major destination for Chinese direct investment.

So a deepening of financial ties with China will help expand trade and investment, and also do it more efficiently. And even small transactional benefits can add up to large cost savings. RMB invoicing, for instance, can lower the cost of transactions by cutting out the need for an additional currency leg, producing small but real benefits for business.

Australia is China's dominant supplier of commodities like iron ore. But Australia's position as a commodity producer does not mean we must live in a purely US$ dominated world of trade invoicing. China is developing its capability in commodity exchange trading and key exports like iron ore are increasingly exchange-traded. These transactions can potentially be settled in RMB.

Last month, Rio Tinto and Bao Steel settled a sale of over 170,000 tonnes of iron ore in RMB, valued at over RMB114 million. So we can see that, despite the dominance of the USD for commodity pricing, Australian mining companies are entirely capable of conducting business in RMB.

China is pursuing a staged approach to reform and Australia is working cooperatively with the Chinese authorities as they continue to roll out new reforms. As I pointed out earlier, Hong Kong is still an important testing ground and financial gateway to China, and has been a trusted and constructive partner for Australia for many years.

Governments have a role in supporting markets but it is ultimately the private sector that must grasp the opportunities. Many banks and corporates have already seen the benefits of being an early mover in the RMB market.

There is significant potential to further harness the opportunities from China's financial opening. At the same time, we should be careful about believing in one-way bets, such as continuous RMB appreciation, and businesses need to be aware of the risks on the downside as well as the upside, and hedge appropriately.

We also should not be put off by potential 'speed bumps'.

Australia has a lot to bring to the table, and much to gain.

Growing trade and investment ties between Australia and China make Sydney a natural destination for the next RMB offshore hub. Australia has the benefit of the expertise of our local financial institutions as well as foreign banks, with their strong and growing presence, especially in the Sydney market. Among these are the five major Chinese banks with branch status in Australia along with HSBC, which has long been active in the Australian market.

While there is competition to be an early mover in the offshore RMB market – be it from Singapore, Taipei or London – cooperation among offshore users of RMB will help the overall market expand and allow each region to realise the benefits of greater financial integration.

There is a growing pool of savings in the region. And, to finance the region's substantial infrastructure needs, a number of initiatives have been introduced to put those savings to use. Key initiatives with the potential to do so include the Asian Bond Funds, the Asian Bond Markets Initiative and the ASEAN Infrastructure Fund. The mutual recognition agreement covering collective investment schemes currently being negotiated between Hong Kong and the mainland also has the potential to unlock savings in the region.

The same could be said for the Asia Region Funds Passport. The Passport will facilitate cross-border trade in collective investment schemes by overcoming key regulatory impediments. In doing so, the passport could help recycle savings towards productive investments across the region.

The most recent milestone in the development of the Passport was last month's release of a consultation paper in a number of regional economies. Hong Kong's Securities and Futures Commission contributed its expertise to the development of the proposed arrangements, and Australia would welcome Hong Kong's participation when the Passport commences in early 2016.

Australian policy makers and financial market players are keenly aware of the changing global financial landscape, as well as the need to ensure that the Australian architecture supports integration with Asia.

The Australian Government's decision to launch a major inquiry of our own financial system recognises this. Indeed, the Financial System Inquiry includes an International Advisory Panel, one of whose members is Andrew Sheng, a name well-known to this audience.

The Financial System Inquiry will consider Australia's international competitiveness, availability of financial services, and emerging opportunities and challenges from changes in the global financial system.

The shift in global economic weight towards Asia – which is already well underway – will herald a similar shift in financial weight. It will also be front of mind as we, in Australia, consider the future direction of our financial system.

Conclusion

Let me in conclusion highlight the fact that considerable progress has been made in recent years. And yet we are only at the very start of a journey that is contingent on China's successful navigation of what is – to say the least – a challenging domestic reform agenda.

Events like today's Dialogue provide us with an opportunity to advance collaboration with our Hong Kong partners, who are leading the way in the RMB internationalisation process.

I would like to thank you again for your continued support to the Dialogue.